



MAY 5, 2009



William A. Harris, CFA
Portfolio Manager

The Pandora Process

Trust, a mighty god, has gone. Restraint has gone from men, and the Graces, my friend, have abandoned the earth. Men's judicial oaths are no longer to be trusted... and men no longer recognize the rules of conduct or acts of piety.

Theognis of Megara, 6th Century BC

Numerous versions of the Pandora myth have passed from ancient Greece through song and spoken verse, across chalky tablets and fading parchment on down to Wikipedia. Here is mine.

The gods filled a box with wonders and torments and gave it to Pandora. They warned her vaguely to take care with it, even as they pressed it upon her. Pandora now beheld a thing of beauty and seeming power, inlaid with rare stones and electrum, and engraved with inscrutable words and symbols she regarded with a puzzled awe. "Truly, this box and all it contains must be good, for it is so lovely though I understand it so little."

You can guess what happens next. Pandora pops the top off, and with a big *whoosh* all the good stuff rushes up Mount Olympus out of mankind's reach. She claps it shut, but too late – the bad stuff has slipped loose to tear about the earth evermore.

Now, picture Pandora lifting her eyes to Olympus and frowning a little as the newly unleashed miseries shuttle about her, lifting her robes and kicking her shins. "Please. I want another box."

Whether or not we want more boxes these days, the powers-that-be stand ready to slap one together at a moment's notice. Periodically, another drops down on our heads: GCLI, TARP, TALF, PPIP (evidently solutions require a longer name to outmuscle the briefer acronyms CDO, ABS, MBS, and CDS). Each brings the prospect of improvement, but also of mischief and new miseries. Much of this is because the measures seem concocted on the fly, and by many of the same illuminati – public officials and private players alike – who delivered us Box One ornamented with easy leverage, whizbang complexity and underregulated securitization.

At heart, the Pandora Process is about mistaking process itself for fundamentals. But our future wealth and that of our nation will derive not from FASB's tinkering with mark-to-market rules, nor from how other G-20 members prefer financial regulation to fiscal stimulus, nor from the IRS allowing REITs to distribute new shares in lieu of cash dividends, nor from which banks pass their stress tests or which executives get to keep their jobs, nor from whether the government ends up owning common or preferred equity stakes in the firms it's sustaining into the zombie zone.

Prosperity will derive rather from how many of us are working and how much we produce, and from how much we owe and to whom we owe it. By these measures we're not yet better off despite the Fed's ballooning its balance sheet and teaming with the Treasury to stretch authority to creative extremes. Monetization is at high tilt and stimulus is ramping, but the rot's still in the system.

I wrote the following in December 2007

(<http://www.allencapital.com/InvestmentUpdates/IU0712.pdf>):

"Intervention has thus far kept the system running – process remains intact – but there's a fundamental problem with pushing debt as a remedy for debt. Mid-mudslide, the central banks are trying to rebuild by scooping the muck right back into place, piling still more on top as the base continues to give way.

While liquidity intervention makes for an orderly settlement of obligations (a fine thing), it cannot cure disproportion in the magnitude of debts, nor can it generate real wealth with which to service or pay them down. It can promote solvency where assets exceed liabilities, but it cannot substitute for solvency when asset values are eroding even as debt levels stay fixed and their "cost of carry" sticks or climbs higher."

The main change is that process now is not intact so much as in flux. Our "gods" have yet to grapple with the bedrock challenges. We still face disproportion in our debts, difficulty paying them down, and costs of carry heading higher as low rate corporate and commercial real estate debt matures into wide yield spreads and a big round of mortgage resets draws closer on the calendar.

Back to the myth. In clapping the lid shut, do you know what Pandora kept from slipping out? Hope alone remained. It will be a while, I think, before we know if the box is Hope's larder or its prison.